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Family Farm

The Next Generation

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INTRODUCTION

A humorous take on how families pass on businesses, such as family farms, is reflected in this quip: *Avenge your children; give them equal shares in your business*. Certainly, what can seem like a generous, wonderful thing can be rife with conflict and imbalance, if you don't take steps to implement the appropriate legal framework.

Landowners, ranchers, and farmers face unique challenges surrounding how to preserve the family farm; a symbol of their heritage. This report focuses on the legal and management issues of managing the family farm, and steps you can take to ensure the smooth transition from generation to generation with ease and accuracy.

PLANNING IS KEY

Whether your family is running a farm, managing a large parcel of land, or operating a chain of feed stores, transitions in stock ownership — either through death, retirement, divorce, or just the desire to sell one's shares — can cause turmoil in the family. But harmony can be maintained, and many difficult family business circumstances can be anticipated and planned for, if everyone agrees in advance how situations will be handled. The key word, however, in this statement is: advance. As with most situations, being prepared ahead of time means the difference between getting it right and seeing it with hindsight.

For this purpose there are *buy-sell agreements*, which are basically contracts that specify certain rights among the owners of a family business.

Sometimes a buy-sell agreement is incorporated into a Living Trust, other times it is a separate document. But in any event, the estate planning attorney needs to coordinate the distribution of the assets between the children receiving the business and the children not receiving the business.

WHAT IS A BUY-SELL AGREEMENT?

One might lightly define a buy-sell agreement as a document that staves off family mud wrestling. But, legally speaking, a buy-sell agreement is a contract that serves four purposes:

1. Formalizes who controls ownership of the business.
2. Focuses on shareholders' rights to transfer stock in the business to other people.
3. Determines what circumstances activate those rights.
4. Details how such transfers might be accomplished.

WHO HAS CONTROLLING OWNERSHIP?

Most buy-sell agreements restrict who may be an owner of the business. In family businesses, it is often understood that only lineal family members (or possibly spouses) can be shareholders.

Commonly, with family farms, there is only one child interested in seeing to it that the farm continues. With a buy-sell agreement, you can formalize a contract that will allow this child to continue the family tradition. At the same time, you ensure that others — uninterested in the sunrise-to-sundown lifestyle — still get their fair share when their farming parents pass away.

WHAT ARE BUY-SELL TRIGGERS?

There are some key elements of a buy-sell agreement that need to be addressed. A course of action must be determined in the event of certain "triggers." Triggers are occurrences such as death, disability, retirement, reaching a certain age, or even a divorce that *obligate* shareholders (or their estates) to sell shares in a family business. Identified buyers are then *required* to purchase upon that event. For instance, let's imagine a family with four children. The parents pass away, and are survived by three city-dwelling children who wish to sell their interest in the farm, and one sibling who wishes to carry on the farm. The "trigger" is their death, and what takes place next must be outlined in painstaking detail in your new buy-sell agreement. Where do you start?

PRICING THE FARM

Pricing the farm can be a relatively easy task. And in your buy-sell agreements, you will provide a method for pricing the family business. However, too often, federal estate tax considerations drive how a price is achieved. The IRS can throw out unreasonably low buy-sell prices, and make that same price binding to the estate of a shareholder. The result? Less money to pay higher estate taxes. You should work with an experienced estate planning attorney on this issue to reach the proper pricing when it's time to value the farm.

Typically, buy-sell agreements put forth a formula price of a company's appropriate value, or direct that one or more outside appraisals is obtained when the triggering event occurs. Common formulas for purchase prices include:

- Book value
- Book value adjusted to the fair market value of certain assets and liabilities
- A multiple of earnings
- A multiple of weighted earnings over a period of time
- A combination of book value and a multiple of weighted earnings

WHAT'S A "FAIR" PRICE?

Let's look at a sample scenario using the family we mentioned earlier. At a recent meeting, the family discussed selling the farm. The three city-dwelling children were still set on their cosmopolitan lifestyle, and basically wanted to know how they could get the best value for their shares. How would they sell their shares, and how would a fair price for the farm be obtained?

While this question is not uncommon, the answer to it can be fairly complex. Here, the key word is "fair," and hopefully it applies to the process of valuing the farm, as well as the price — and to everyone in the equation. Some would say the best route is to use a professional valuation specialist who can study the farm and determine its worth. Others say: There's no market for these shares, and they don't need to pay anything. Fairness lies between these two extremes. Finding a balance is the key.

By meeting with your estate planning attorney to create a buy-sell agreement, you can establish the appropriate means whereby family members can sell their shares. As to "fair" price, families often like to keep the price low to minimize estate taxes. Keep in mind that full market price is available only if the business is sold.

IF IT'S A FARM, A RANCH, OR A FEED STORE

The appropriateness of any of the pricing formulas discussed earlier is determined by *the nature of the business.* For example, book value may be totally inappropriate for valuing a farm. Where a formula purchase price is to be used, it is always advisable to ask your attorney about using an appraisal firm or valuation expert to assist in the development of a formula that will be truly reflective of your business' continuing value.

SUCCESSION PLAN ELEMENTS

It's important to note that succession planning, a broader term for "the creation of a buy-sell agreement," is only one part of estate planning. Although your will and trust may be in great shape, the succession plan for passing on the family farm may be a disaster waiting to happen. That's why it's important to use a buy-sell agreement.

How do you know when you've covered all the bases? A good succession plan addresses five basic issues:

1. **Business opportunities and risks**. A strategic assessment will determine if you should keep or sell the business. Evaluate the current value of the business, methods needed to improve business value, and any factor that might potentially reduce business value.

2. **Generation differences**. Are there discrepancies in the way the current generation runs the business and how the next generation may run it? The skills required for the next CEO may be quite different from what worked for the current CEO.

3. **Ownership models**. First-generation companies tend to use an owner-manager model of ownership: The owners work in the farm and derive their "ownership benefits" from compensation and other deductible perks. Second and third generation companies are often sibling or cousin-owned and use a hybrid ownership model, with some family members active in the business and some not active, but involved as owners. As companies evolve, they may use an owner-investor model, in which ownership is held in family entities such as family limited partnerships or trusts. We can help you determine which is right for you.

4. **Leadership and management**. Is there a shared vision for the farm? If so, who in the next generation possesses the passion and competence to implement this vision?

5. **Personal/family issues**. These issues are emotional as well as financial. Here is where you address the fairness/equalization issues when your three city-dwelling children are not interested or active in the farm, yet your one child is active and would like to continue running the business.

MORE LENIENT ESTATE TAX PAYMENT RULES FOR FAMILY FARMS

One of the advantages of holding the family farm is the leniency of certain federal estate tax laws. Due to the uniqueness of farms and other closely held businesses, certain relief provisions come into play to help families meet tax costs.

For instance, farms may be valued at their current business use rather than at the highest-and-best-use (up to a decrease in valuation of $1,140,000 in 2018). But keep in mind: selling the business within 10 years after the decedent's death, or no longer using it for business, triggers a "recapture" tax, which means you lose the tax-saving benefits of the special use valuation and must pay additional tax.

There are other benefits to holding the farm:

- The regular 9-month pay-now deadline for estate tax is ignored for an active family farm or closely-held business, if certain criteria are met.

- The estate tax attributable to business interests can be paid in installments over a period of up to 14 years at low interest rates.

- Interest payments on the deferred tax are due only for the first four years, followed up by annual installments of interest and principal for the next 10 years.

- A portion of at least some of the interest on the deferred payments is at 2% on the first $1,520,000 in taxable value in 2018. Breaking up the business as well as tardy installments, however, can jeopardize the deferred payment plan.

PROTECTING YOUR FAMILY FARM

We encourage families to enact shareholders' agreements that clearly lay out the conditions and terms of sales long before anyone wants to cash in their inheritance. When those mechanisms are in place, then being "fair" usually means keeping the farm and the remaining shareholders intact. After all, the stock in family businesses is most often a gift from a previous generation that wanted to encourage family ownership and continuity.

And remember, buy-sell agreements are as important to businesses with more than one shareholder as wills are to individuals. They provide solutions to potential conflicts before the conflicts arise and thus, save tremendous time, pain and expense. Moreover, well-constructed buy-sell agreements can protect both individual shareholders and the business by providing a way to achieve liquidity while keeping demands for funds manageable. Don't wait for conflicts to make reaching a buy-sell agreement impossible. If you don't have one, call our office and develop an agreement to support your family's business goals.

THE IMPORTANCE OF SHARED GOALS

Many families carefully distinguish the roles and responsibilities of members in the business to minimize the chance of familiar conflict. The Gallo brothers, Ernest and the late Julio, provide an interesting example. As chairman, Ernest controlled marketing, sales and distribution for the giant winery. Julio was president and oversaw production. Their offices were on separate floors and they did not have daily contact. They managed to mesh effectively through shared goals. Julio's goal was to make more wine than Ernest could sell, while Ernest sought to sell more than Julio could make.

This interesting example is necessary to consider when determining the importance of a family squabble over who will run what part of the family farm. It's best to use a combination of perspectives and sound business sense when defining your organizational hierarchy.

TAKING THE STEP: ESTABLISHING A BUY-SELL AGREEMENT

Creating a buy-sell agreement can help you achieve tax advantages and control with respect to your family farm. Equally important is the peace of mind you'll gain when you know your children will be well provided for and your legacy will be passed on in a highly structured and cost-efficient way.

Because your goals and your family's situation are unique, we can provide you with assistance on estate planning strategies specifically created for farms. Our experienced team will show you how to best employ these strategies for your family’s greatest benefit.

ABOUT THE ACADEMY

This report reflects the opinion of the American Academy of Estate Planning Attorneys. It is based on our understanding of national trends and procedures, and is intended only as a simple overview of the basic estate planning issues. We recommend you do not base your own estate planning on the contents of this Academy Report alone. Review your estate planning goals with a qualified estate planning attorney.

The Academy is a national organization dedicated to promoting excellence in estate planning by providing its exclusive Membership of attorneys with up-to-date research on estate and tax planning, educational materials, and other important resources to empower them to provide superior estate planning services.

The Academy expects Members to have at least 36 hours of legal education each year specifically in estate, tax, probate and/or elder law subjects. To ensure this goal is met, the Academy provides over 40 hours of continuing legal education each year. The Academy has also been recognized as a consumer legal source by *Money Magazine, Consumer Reports Money Adviser* and Suze Orman in her book, *9 Steps to Financial Freedom*.

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